Profile of the Economy

[Source: Office of Macroeconomic Analysis]

Real gross domestic product (GDP)

Growth in real GDP strengthened to a 2.0 percent annual rate in the first quarter of 2001, according to the advance estimate. Although this was double the small 1.0 percent annual rate of growth in the fourth quarter of 2000, the first quarter increase was still below most estimates of the economy's potential rate.

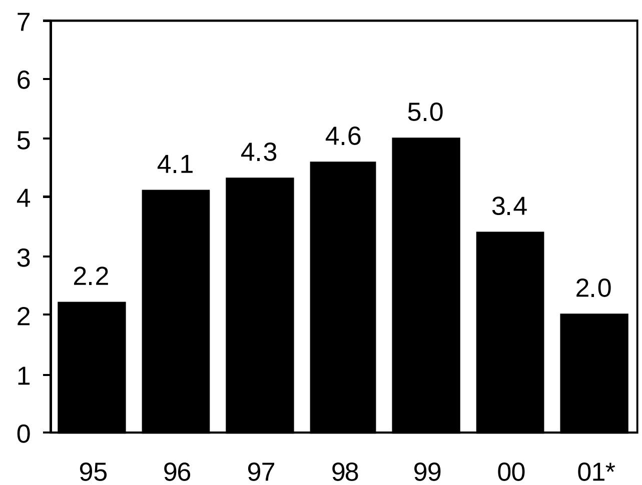
Growth was led by a 3.1 percent annual rate increase in personal consumption expenditures and by a substantial drop in imports. Exports edged down as well but by much less than imports. The reduction in the foreign trade deficit added 1.4 percentage points to GDP growth, only the second time in 4 years that the quarterly trade deficit narrowed.

Investment in equipment and software decreased at a 2.1 percent annual pace in the first quarter after falling 3.3 percent in the fourth. Those were the first back-to-back declines in this category since the 1991 recession. There was a large inventory correction in the first quarter that subtracted 2-1/2 points from real GDP growth. Much of the reduction in inventories and in equipment investment came out of imports.

The national accounts measures of inflation accelerated in the first quarter primarily because of higher food and energy prices, the annual Federal pay raise (which is treated as a price increase), and a pickup in prices for consumer services. The GDP price index rose at a 3.2 percent annual rate in the first quarter compared with 2.0 percent in the fourth quarter. Excluding food and energy, the core rate moved up to 2.3 percent from 1.9 percent.

Growth of Real GDP

(Percent change, fourth quarter to fourth quarter)



* Based on first quarter

Inflation

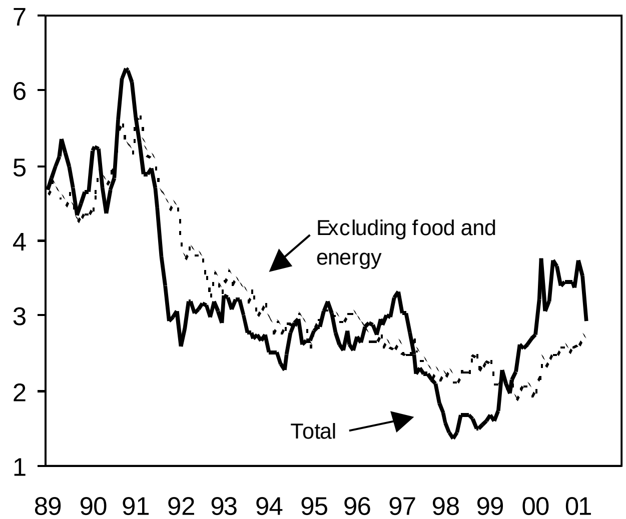
Inflation picked up in the first 3 months of 2001. Productivity growth was little changed in the first quarter and hourly compensation rose by a sizable amount, resulting in higher labor costs.

Consumer prices increased at a 4.0 percent annual rate for the 3-month period ending in March, an acceleration of a little more than 1/2 percentage point from the previous year. Prices jumped sharply in January before registering more moderate increases in February and March. Core Consumer Price Index (CPI) inflation (excluding the food and energy components) picked up to a 3.5 percent pace during the first 3 months of the year from 2.6 percent in 2000. Food prices rose at a 4.1 percent annual rate, an acceleration of about 1-1/4 percentage points from the previous year. Energy prices were up at an annual rate of 6.0 percent, well below the double-digit increases registered in the previous 2 years.

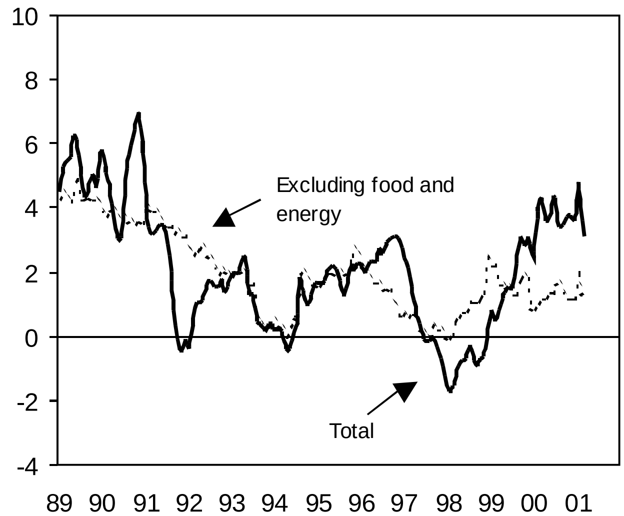
At the producer level, the pattern for finished goods prices so far this year has generally mirrored developments at the consumer level. Finished goods prices rose at a 4.9 percent annual rate during the first 3 months of the year, up from 3.6 percent in the previous year. Virtually all of the increase occurred in January. Core inflation continued to be moderate, increasing at a 1.9 percent rate during the first quarter. This was still at a slightly faster rate than the 1.2 percent increase in 2000. The increase in energy prices slowed to an annual rate of just under 11 percent during the first quarter of the year from more than 17 percent last year. Further back in the production chain, core prices for crude goods dropped by 12-1/2 percent while core intermediate goods prices moved up at a moderate pace.

Productivity in the nonfarm business sector edged down by 0.1 percent in the first quarter of 2001, following strong gains over the last several years. Hourly compensation costs rose by 5.2 percent in the quarter, pushing unit labor costs up by a similar 5.2 percent. The employment cost index for total compensation, a separate compensation measure that also is closely watched, increased by 4.1 percent for the 12-month period ending in March. This was less than the increase in compensation in the productivity series (which includes stock options) and a slight deceleration from the 4.3 percent gain during the year ending in March 2000.

Consumer Prices
(Percent change from a year earlier)



Producer Prices - Finished Goods
(Percent change from a year earlier)



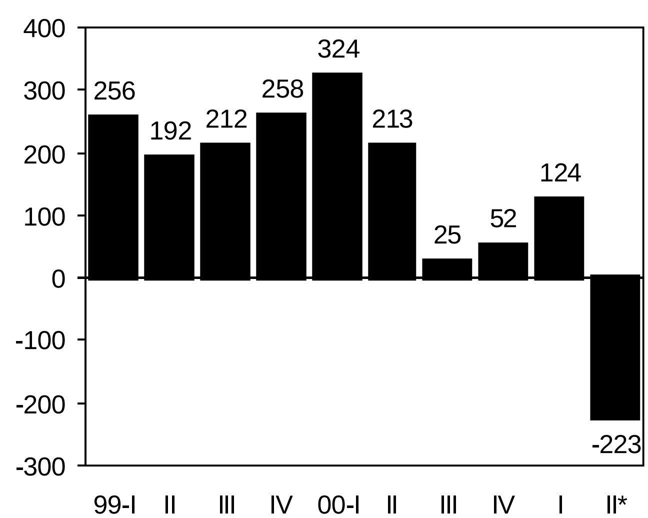
Employment and unemployment

Payroll employment has declined in recent months, and the unemployment rate has risen to 4.5 percent. Despite the emergence of weaker labor market conditions, wage growth has shown no signs of slowing.

Employment on nonfarm payrolls plunged by 223,000 in April 2001 on top of a 53,000 decline in March. The April loss was the steepest since February 1991, when the economy was officially in recession. The downturn recorded in the 2 latest months followed a year-long slowdown in payroll growth characterized by notable job losses in the manufacturing sector. Steady declines in factory employment since the middle of 2000 resulted in 550,000 fewer jobs by April 2001. Weakness in manufacturing likely contributed to steep job losses in the temporary help supply industry, which places a large portion of workers in factory jobs. Temporary help supply businesses have slashed payrolls by 370,000 since September 2000. The private service-producing sector (excluding help supply) continued to hire in April, albeit at a very sluggish pace compared to just a few months ago. The construction industry shed 64,000 workers in April, but strong gains averaging 62,000 per month in the first quarter and wet weather in parts of the country may have played a role.

Unemployment Rate
(Percent)

Establishment Employment
(Average monthly change in thousands)



*Based on April data

The unemployment rate rose from 4.3 percent in March to 4.5 percent in April, the highest reading since October 1998. This suggests some loosening of labor market tightness since last fall, when the unemployment rate reached a 3-decade low of 3.9 percent. The labor force participation rate eased to 67.1 percent in April from 67.2 percent in the prior 2 months but remains well within the range of recent experience.

Nominal wage gains, as measured in the payroll employment survey, have yet to moderate but still remain relatively tame. Average hourly earnings of production and other nonsupervisory workers grew by 4.3 percent over the 12 months ended in April, up from 3.8 percent in the year-earlier period but still less than the 4.4 percent gain posted in early 1998. Adjusted for inflation, average hourly earnings increased by a strong 1.4 percent during the year ended in March, building on the gains registered since 1995.

Real disposable personal income and consumer spending

Personal income in nominal terms rose at a 5.9 percent annual rate in the first quarter of 2001. This was up from an increase of about 4 percent in the fourth quarter of 2000 but close to the pace registered over the previous 2 years. Wage and salary disbursements (58 percent of income) continued to rise at about a 6-1/2 percent annual rate in the first quarter. Strength was concentrated in the distributive and service industries, and in government wages and salaries, which were boosted by the annual cost-of-living adjustment for Federal civilian and military personnel. Manufacturing payrolls declined in the first quarter for the first time in 7 years, contributing to a deceleration in wage growth in the goods producing industries. Interest payments slowed in the first quarter of the year, reflecting declines in interest rates.

On a real after-tax basis, personal income rose at a 2.0 percent annual rate in the first quarter of 2001. This was close to the 2.2 percent increase last year but down from 3.1 percent registered in 1999.

Real consumer spending was up at a 3.1 percent annual rate in the first quarter, close to the 2.8 percent rate in the fourth quarter but off from the 4.5 percent pace for all of last year. Growth of expenditures on durable goods rose sharply, led by a near 20 percent annual rate increase in spending for motor vehicles. Manufacturers' incentive programs aimed at reducing inventories contributed to the first quarter jump in consumer spending on motor vehicles. Spending on services only grew by 1.7 percent in the first quarter, the smallest increase in more than 2 years. Sharp increases in energy costs were a factor.

With real consumer spending growing at a faster pace than after-tax income, the personal saving rate moved down to -1.0 percent in the first quarter from a negative 0.7 percent in the fourth quarter. For all of last year, the personal saving rate was -0.1 percent, down from a recent high of 8.7 percent in 1992. This was the first time that the saving rate had been negative since the midst of the Great Depression in 1933. Of course, the circumstances are entirely different today. Even with the decline in equity markets during 2000 and 2001, household net worth has benefited from tremendous gains in the stock market in recent years. This "wealth effect" has been a major factor behind the decline in the personal saving rate. Increases in asset values are not counted as income in the national income and product accounts, from which saving is calculated, but nonetheless contribute to the willingness and ability of consumers to spend.

Industrial production and capacity utilization

Output in the industrial sector declined for the seventh straight month in April 2001, falling by a seasonally adjusted 0.3 percent. Due to downward revisions in the previous month's data, the first quarter showed a 6.5 percent annual rate contraction. This was the largest quarterly decline since the 8.3 percent drop in the first quarter of 1991, when the economy was in recession. Over the past 12 months, industrial production has fallen by 1.0 percent—a dramatic reversal from year-over-year gains of around 6-1/2 percent registered last spring.

Manufacturing production, which accounts for just over 87 percent of all industrial output, also declined by 0.3 percent in April, on top of a dramatic 7.7 percent annual rate drop in the first quarter of 2001. Production of motor vehicles and parts, which has played a significant role in the recent contraction in the factory sector, was flat in April. There were sizable declines in such cyclically sensitive sectors as industrial machinery and equipment and electrical equipment.

The high-tech sector, which includes computers, communications equipment and semiconductors, has been slashing output in recent months due to an inventory overhang. Although declines in this sector have not yet approached the magnitude of other manufacturing industries, the slowdown since last spring has been quite remarkable. After growing by 25.2 percent at an annual rate in the fourth quarter of 2000, production in the high-tech sector declined by 4.3 percent in the first quarter of 2001. Excluding high-tech, manufacturing production fell by 0.3 percent in April and by 8.2 percent in the first quarter.

The rate of industrial capacity utilization, which has been edging downward for 8 consecutive months, dipped to a 10-year low of 78.5 percent in April. This rate is 5.9 percentage points below the expansion peak of 84.4 percent achieved in early 1995 and 3.5 points lower than its long-term average.

Nonfarm productivity and unit labor costs

U.S. productivity tapered off in the first quarter of 2001 from the extremely strong readings of recent years. Nonfarm business productivity (real output per hour worked) fell by 0.1 percent at an annual rate, the first decline since the first quarter of 1995. The latest reading stands in contrast to the solid 2.0 percent rate of increase in the fourth quarter and the strong 3.3 percent rate of growth for all of 2000. During the 5 years from 1995 to 2000, nonfarm productivity advanced at a 2.9 percent annual rate, the fastest rate of growth for any such period since 1968. While the latest quarter represents a significant fallback from this trend, the quarterly productivity numbers tend to be extremely volatile.

Hourly compensation costs in the nonfarm business sector rose at a 5.2 percent annual rate in the first quarter after jumping by 6.0 percent or more in each of the previous three quarters. Over the latest four quarters, growth in hourly compensation has accelerated from 4.5 percent a year earlier to 6.0 percent in the first quarter—a pace not seen since the first quarter of 1992. The decline in productivity, coupled with a sizeable increase in compensation, caused unit labor costs to surge by 5.2 percent at an annual rate in the first quarter. This boosted the four-quarter increase to 3.1 percent, up from 2.3 percent during 2000. The sharp rise in unit labor costs threatens to intensify a squeeze on unit profits that developed in the second half of last year.

Productivity growth in the manufacturing sector slowed to a narrow 0.3 percent annual rate in the first quarter from 5.5 percent in the fourth quarter and 6.7 percent during all of last year. From 1995 to 2000, manufacturing productivity averaged a 5.4 percent annual rate of advance—strength unprecedented in the post-World War II era. Hourly compensation increased at a 4.7 percent annual rate in the first quarter, slower than the 6.2 percent pace last year. Factory unit labor costs rose by 4.4 percent at an annual rate in the first quarter, after having fallen on average in each of the past 7 years.

Current account balance

The current account measures trade in goods and services as well as the flow of investment income and unilateral transfers. The current account has been in deficit almost continuously since the early 1980s. In the fourth quarter of 2000, the current account deficit swelled to $461 billion at an annual rate. That brought the deficit for the entire year to a record high $435 billion, or 4.6 percent of nominal GDP.

The current account deficit has widened substantially over the past decade primarily because of a deterioration in the merchandise trade balance. Growth in U.S. domestic demand has outpaced that of our major trading partners, causing imports to grow much more rapidly than exports. The appreciation of the dollar in recent years and higher prices for imported oil since 1998 also have contributed to the burgeoning trade gap. As a result, the deficit on merchandise trade has more than doubled since the mid-1990s, reaching a new high of $473 billion at an annual rate in the fourth quarter. Significant improvement was recorded in the first 2 months of 2001, however, as demand for merchandise imports softened notably.

Other major components of the current account also have fueled the growing deficit. The surplus on trade in services has narrowed somewhat since 1997. Moreover, what had been a positive balance on investment income turned negative in 1998, as weak foreign growth depressed interest earnings on U.S. investments abroad and U.S. growth supported strong interest income on foreign investments in the United States. The balance on investment income swung back into positive territory once again in the fourth quarter, however. The improvement was attributed to a large increase in direct investment receipts.

The current account deficit is, by definition, matched by offsetting transactions in the financial and capital accounts, with any difference in the recorded flows listed as a statistical discrepancy. Continuing inflows of foreign funds reflect the attractiveness of the United States as an investment outlet. In the final quarter of last year, the financial account recorded inflows for foreign assets in the United States that exceeded outflows for U.S. assets abroad by $347 billion at an annual rate, down from $408 billion in the third quarter and a huge $611 billion net financial inflow recorded in the second quarter. The moderation was due in large part to a doubling of financial outflows for U.S.-owned assets abroad, which outweighed a jump in foreign acquisitions of assets in the United States. For the entire year, net financial inflows totaled $399 billion, up from $323 billion in 1999.

Exchange rate of the dollar

Since the end of 1999, the exchange rate of the dollar against a broad index of 26 currencies of important U.S. trading partners has strengthened significantly, rising by 9.5 percent over the 16 months ended in April 2001. This followed a 2-year period of relative stability after a sharp increase in 1996 and 1997.

Nearly all of the appreciation since 1999 has been fueled by improvement of the dollar against the currencies of the United States' major trading partners, including the euro-area countries, Canada, Japan, the United Kingdom, Australia, Sweden and Switzerland. Between January 2000 and April 2001, the exchange value of the dollar in relation to the currencies of the United States' major trading partners jumped by 12.8 percent. The dollar/euro exchange rate climbed by 13.5 percent during the same period, and the dollar/yen exchange rate rose by 17.5 percent.

The strength of the dollar mainly reflected the faster pace of growth in the United States. The perception that U.S. asset markets would continue to present generally attractive investment opportunities relative to foreign markets also contributed to the stronger performance of the dollar. Other factors such as differing central bank policies and concerns over foreign exchange policy, the course of structural reforms in the euro area and the pace of Japan's economic recovery also have played a role.

Interest rates

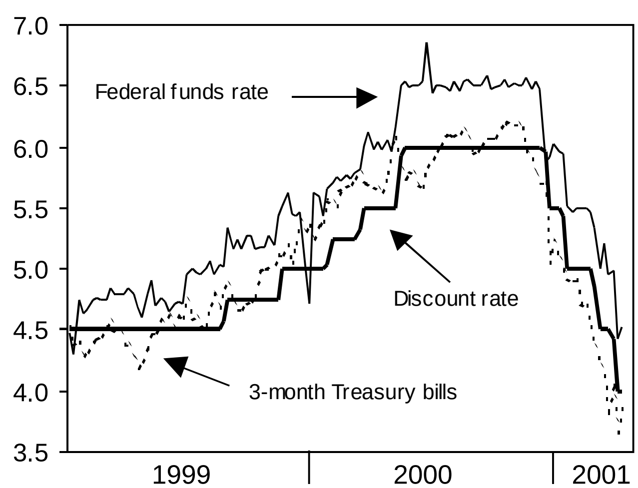
The Federal Reserve eased monetary conditions in the first 5 months of 2001. It cut interest rates five times over that span by 50 basis points each time. The Federal Reserve described its actions as the appropriate policy in light of weak consumer and investment demand due to lower confidence, tighter credit conditions, and the effect of high energy prices on household purchasing power and business profits. In announcing its latest reduction on May 15, the Federal Reserve noted that profit expectations and the business outlook overall seem “likely to hold down capital spending going forward.”

The easing trend followed a period of nearly a year during which interest rates were left unchanged. The actions lowered the target for the federal funds rate (the rate that banks and other financial institutions charge each other for overnight loans) from 6.5 percent at the end of December to 4.0 percent by mid-May. The discount rate (the rate the Federal Reserve charges banks for short-term funds) was lowered from 6.0 percent to 3.5 percent. The market interest rate for the 3-month Treasury bill, which usually centers around the level of the discount rate, moved down to about 3.6 percent.

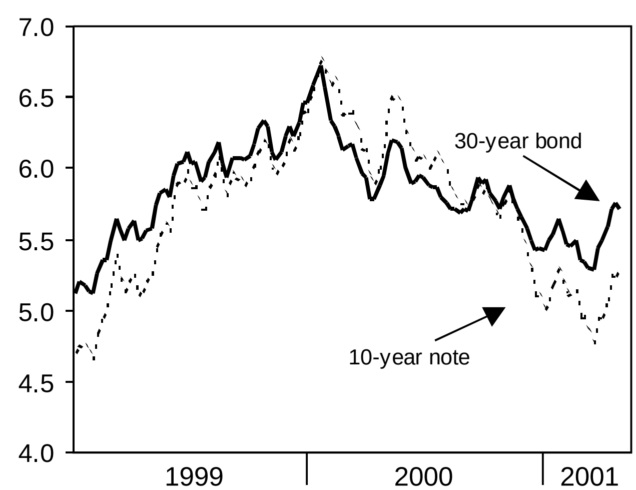
Rates on long-term Treasury securities declined through most of 2000 and in early 2001 but then turned upward in April. Long-term rates are influenced by a number of factors. The downtrend in the bond yield, which moves inversely to its price, partly reflected a shrinking supply of Treasury securities due to growing budget surpluses. Weakness in equity markets and in the economy in general last year, as well as uncertainty about prospects going forward, contributed to the decline as well.

Mortgage interest rates generally follow the pattern of the 10-year Treasury note. The interest rate on a conventional 30-year fixed rate loan declined from a recent peak of 8.5 percent in May 2000 to 7 percent by the end of last year. The rate has held at about that level through the first 4 months of 2001.The decline of roughly 150 basis points in the mortgage interest rate prompted some renewed strength in housing demand during the latter part of last year and into 2001.

Short-term Interest Rates
(Percent)



Long-term Interest Rates
(Percent)



Housing

Housing continued to be a strong sector of the economy in the first quarter of 2001. Sales of new single-family homes averaged 990,000 at an annual rate in the quarter, well above the selling pace of 904,000 in 2000 and the record 907,000 in 1999. In the month of March, new home sales hit an all-time high of 1.021 million at an annual rate. Sales of existing single-family homes also were strong through the first quarter, and in March were just shy of their all-time record. A decline in mortgage interest rates over the second half of last year and into 2001 provided support for the high level of home sales. The mortgage rate for a 30-year loan fell by about 1-1/2 percentage points since last May and in the first quarter averaged a low 7 percent.

A high level of sales of both new and existing homes over the past several years led to a dramatic increase in home ownership. The number of new homeowners grew by 11 million during the 1990s, and the home ownership rate rose to a record 67.6 percent by the first quarter of 2001. Expansion in home ownership has been particularly notable for minority groups.

Construction of new housing units lagged behind new home sales in the second half of 2000. This led to a reduction in the inventory of new houses for sale and a decline in residential investment in both the third and fourth quarters. By the first quarter of 2001, construction began to catch up with demand. Housing starts jumped 23 percent at an annual rate in the first quarter, and real residential investment increased at a 3.3 percent pace.

Federal budget

The Federal budget posted a unified surplus of $237 billion in fiscal 2000, or 2.4 percent in relation to GDP. That was the largest surplus ever in dollar terms and the largest relative to GDP since fiscal 1948. The surplus in fiscal 2000 was the third in a row.

Receipts jumped by 10.8 percent in fiscal 2000, the fastest rate of growth since 1987. The increase reflected large gains in the income and wealth of individuals as well as a marked improvement in corporate profits in fiscal 2000, following weakness in the past several years.

Outlays of the Federal Government increased by 5.0 percent in fiscal 2000, an acceleration from average growth of 3.0 percent per year over the prior 7 years. Despite the speedup in spending, growth in outlays was slower than growth in the economy in fiscal 2000, and outlays in relation to GDP declined to the lowest in almost 35 years. Among major spending categories, outlays accelerated in fiscal 2000 for such functions as defense, Medicaid, Social Security and farm price support, among others. Outlays for Medicare, which did not increase at all from 1997 to 1999, began to grow again in 2000. Net interest expenses declined for the third consecutive year as debt owed to the public was reduced.

The budget surplus in fiscal 2000 resulted in a $223 billion reduction in debt held by the public that year. Over the last 3 years, publicly held debt has been cut by a total of $361 billion, or 9.6 percent. At the end of fiscal 2000, debt held by the public represented 34.7 percent of GDP, down from nearly 50 percent 7 years ago and the smallest ratio since 1984.

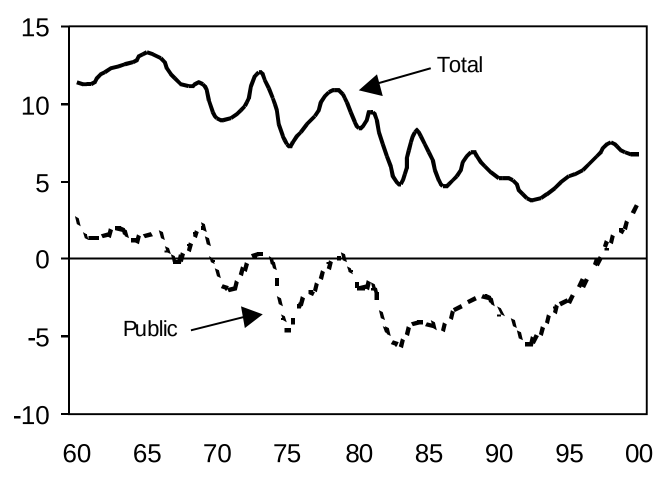
The surplus is projected to rise to $281 billion this fiscal year and continue to grow over at least the next 10 years. Over the fiscal years 2002 to 2011, the cumulative surplus is expected to be $5.6 trillion. About $2.6 trillion of that is off-budget, reserved for the Social Security Trust Fund. The Administration proposes using the remaining on-budget surpluses to reduce taxes, continue to retire the Federal debt and provide a reserve for contingencies.

Net national saving and investment

Net national saving slowed to 6.0 percent of net national product (NNP) in the fourth quarter of 2000 (the latest period for which full detail is available) from an average of 6.7 percent in the first three quarters of the year. (Net saving and NNP exclude depreciation to replace wornout or obsolete equipment, software and structures used in production.) For all of 2000, net saving averaged 6.5 percent. This was down somewhat from 6.8 percent in 1999 and 7.5 percent in 1998 but was well above the 55-year low of 3.9 percent in 1993.

Net National Saving

(Saving as a percent of NNP)



A further decline in private saving to 2.1 percent in the fourth quarter from 3.2 percent averaged in the first three quarters of the year accounted for the weakening in net national saving at the end of 2000. Household saving dropped to -0.6 percent of NNP in the fourth quarter from near zero earlier in the year. Despite falling equity prices last year, wealth generated by the surging stock market in other recent years has reduced the desire of households to save out of current income. (Gains in wealth achieved through higher asset valuations are not included in conventional definitions of saving.) Corporate saving also declined in the fourth quarter but was still positive at 2.7 percent of NNP. For all of 2000, total private saving averaged 2.9 percent of NNP, down from approximately 9 percent in the early 1990s.

The swing in the Federal budget from large deficits into surplus has more than offset the decline in private saving since the first part of the last decade. The total public sector moved from dissaving equivalent to 5.4 percent in 1992 to saving of 3.6 percent in 2000. Most of the improvement was in the Federal budget, although State and local government saving strengthened somewhat, as well. Government saving rose further at the end of last year to 3.9 percent in the fourth quarter from 3.5 percent averaged in the first three quarters of the year.

Net domestic investment (by government and private industry in structures, equipment, software, and inventory) slowed somewhat to 10.2 percent of NNP in the fourth quarter from 10.6 percent averaged in the first three quarters of the year. Even so, the 10.5 percent averaged for the entire year was the strongest since 1984 and was up sharply from a very low 5.2 percent of NNP in 1991. A large portion of this investment has been financed from abroad, as U.S. net foreign investment swung from 0.3 percent of NNP in 1991 to -4.9 percent last year.